Internal Revenue Service

memorandum

CC:FS:TL-N-9265-91
CORP:LEGardner

date: OCT 17 1991

to: District Counsel, Indianapolis CC:IND
Attn: Timothy A. Lohrstorfer

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]
Docket No. [redacted]

We communicated to you verbally on September 26, 1991, our advice on the issue in this case. This is a written response to your request for Tax Litigation Advice, dated August 26, 1991.

ISSUE

Whether a corporation may deduct a settlement payment for damages resulting from a personal injury suit under section 162, where the contingent liability was transferred by a partnership to the corporation in a section 351 transaction, and the settlement was subsequently paid by the corporation.

CONCLUSION

We conclude that based upon the Service's position with respect to such expenses, that this expense is deductible by the successor corporation.

FACTS

We incorporate the facts as noted in the supporting statement sent to this office by District Counsel.

DISCUSSION

The issue in this case is whether a corporation may deduct a settlement payment for damages resulting from a personal injury suit under section 162, where the contingent liability was transferred by a partnership to the corporation in a section 351 transaction, and the settlement was subsequently paid by the corporation. The position of the Service is that, in a section 351 transaction, such a liability is deductible under section 162. In the past, some courts have taken the position that, in a section 351 transaction, an assumed liability is a cost of acquisition and, therefore, such liability is a capital expenditure. The relevant case reaching such a conclusion is Holdcroft Transportation Company v. United States, 153 F.2d 323

(8th Cir. 1946). In Holdcroft, the taxpayer, an Iowa corporation, acquired the assets and assumed the liabilities of a partnership in a section 112(b)(5) transaction (the predecessor of section 351). These liabilities included two claims against the partnership which grew out of an automobile accident between a truck operated by the partnership and another driver. The law suits were still pending at the time the taxpayer acquired the assets and assumed the liabilities of the partnership. The taxpayer settled the law suits and deducted the settlement payments as expenses of its business. The Commissioner disallowed the deduction.

The Eighth Circuit Court of Appeals concluded that the amounts paid in settlement of the law suits against the partnership were capital expenditures on the theory that the payments were part of the cost of acquisition of the property of the transferor and could not be attributed to the transferee because the payments were not claims arising out of the operation of the transferee.

The position of the Service is that the rationale of Holdcroft should not be applied in transactions qualifying under section 351 as long as the transaction is business motivated, does not artificially produce losses for the transferee, and does not distort the income of the transferor or transferee.

Our conclusion is based upon the Service's broad interpretation of section 351 and the principle that income must be clearly reflected.

First, the legislative history of section 351 supports our broad interpretation of section 351. The early legislative history of section 351 indicates that Congress regarded incorporation exchanges as merely changes in form and that congressional intent in enacting the predecessor of section 351 was to eliminate the impediments to business readjustments by making the incorporation tax free. See H. Rept. No. 350, 67th Cong., 1st Sess. 10 (1921); S. Rept. No. 398, 68th Cong., 1st Sess. 17 (1924).

Second, the position of the Service is consistent with the principle that income must be clearly reflected. For example, the position of the Service is that the treatment of expenses payable by the transferee corporation is inextricably tied to the Service's current position with respect to the treatment of accounts receivable. Therefore, where accounts receivable and expenses payable are transferred to a corporation as part of the incorporation of a going business under section 351, the payables should be deductible by the transferee when paid. See G.C.M. 34118.

The Service has published its position with respect to accounts receivables and accounts payables in two revenue rulings and General Counsel Memoranda. In Rev. Rul. 80-198, 1980-2 C.B. 113, a sole proprietorship transferred assets and liabilities, including accounts payable and accounts receivable, to a new corporation in exchange for all the corporate stock, in a transaction which was held to qualify under section 351. The Service noted that there was a valid business purpose for the transfer of the accounts receivable. The Service held that the transferee corporation will report in its income the accounts receivable as collected and will be allowed deductions under section 162 for the payments it makes to satisfy the accounts payable.

In Rev. Rul. 83-181, 1983-2 C.B. 38, payments which would have been deductible by a partnership had the partnership continued in existence, were held to be deductible by the transferee corporation. Again, the Service noted that the congressional intent of section 351(a) is to facilitate necessary business readjustments, and such intent would be frustrated by not according the transferee the right to deduct expenses of the ongoing business which, if not assumed by the transferee, would have been deductible by the transferor. See also G.C.M. 39252; G.C.M. 39258; G.C.M. 39054; G.C.M. 37528.

The instant case involves a contingent liability of a partnership which was later paid by the transferee corporation when a settlement was reached. You have suggested that this fact distinguished the instant case from the position of the Service taken in prior revenue rulings. You have also pointed out that the liability in this case in similar to the deductions disallowed in Holdcroft. This office has concluded that the fact that this case involves a contingent liability does not distinguish this case from prior revenue rulings. Additionally, the fact that the facts in this case are similar to the facts in Holdcroft does not lead us to conclude that Holdcroft should control here because the position of the Service is that Holdcroft is not applicable in section 351 transactions where certain conditions are met, as stated earlier.

Finally, you have raised a factual issue, that the partnership may not be liable for the accident. We have written this advice based on the premise that the partnership would have been entitled to the deduction for the payment of the settlement. If it is later determined that the partnership would not have been entitled to the deduction, further inquiry is warranted. You may then wish to seek the advice of the IT&A branch of Field Service as to whether this would have precluded a deduction by the transferee corporation.

You have stated that the corporation has failed to produce evidence that it affirmatively assumed the debts and liabilities of the partnership. Then, you stated that the corporation makes a convincing argument that Illinois law would hold it liable as the successor-in-interest for any negligence of the partnership. There is no question regarding whether such payment was made or whether the corporation made the payment. The corporation did make the settlement payments. Therefore, we conclude that there is no issue with respect to whether the corporation assumed the liability.

This office assumes that the transaction was business motivated since you have not provided evidence to the contrary. This office also assumes that there is no issue with respect to whether income was clearly reflected by the partnership or the corporation since you have not provided evidence to the contrary. Therefore, based upon the facts provided, we conclude that the corporation is entitled to deduct the payments made in settlement of the law suits.

If you have any questions regarding this matter, please call Lorraine E. Gardner, at (FTS) 566-3335.

DANIEL J. WILES

By: Steven J. Hankin
STEVEN J. HANKIN
Special Counsel Corporate
Field Service Division